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Is the recent EU deal a game changer?

By Angelo Katsoras

Introduction

On July 21, the European Union reached a ground-breaking agreement. It approved a 750-billion-euro recovery fund that, along with loans, included for the first time a substantial amount in grants (390 billion euros) to struggling member countries. Another breakthrough was allowing the fund to be financed through borrowing from the EU. Both of these measures would have been unthinkable without the huge economic shock caused by the pandemic.

The financial aid arrived not a moment too soon. In the second quarter, the Eurozone had seen GDP crumble 40% on an annualized basis and the risk of political instability was growing. Failure to reach a deal would have set off new turbulence in financial markets and raised further questions about the Eurozone's future.

From a long-term geopolitical perspective, however, the following questions must be asked. Does the shared borrowing bring the EU closer together? Or does it risk opening its political fractures even more?

How the deal was negotiated

Europe's €750-billion recovery fund was secured by an unlikely champion: German Chancellor Angela Merkel. She went from being a staunch opponent of having the richer EU countries effectively underwrite the debt of their poorer counterparts to joining France in support of what she referred to as a "one-off" disbursement of grants. Merkel reportedly warned the Dutch leader during negotiations that: "If southern countries go bankrupt, we all go bankrupt eventually."[1]

Getting the agreement approved also required compromising with other wealthier members that initially pushed for the aid to be disbursed solely in the form of loans. This meant cutting the grant portion of the recovery fund from 500 to 390 billion euros and reducing the annual EU budget dues of certain countries. Austria and the Netherlands, for example, got their yearly dues reduced by 565 and 400 million euros, respectively.[2]

Finally, in an effort to get Hungary and Poland to support the aid package, proposals that made access to funding conditional on upholding the rule of law were eliminated from the final draft. In the last few years, both these countries have been accused of imposing undue political pressure on their judicial systems.

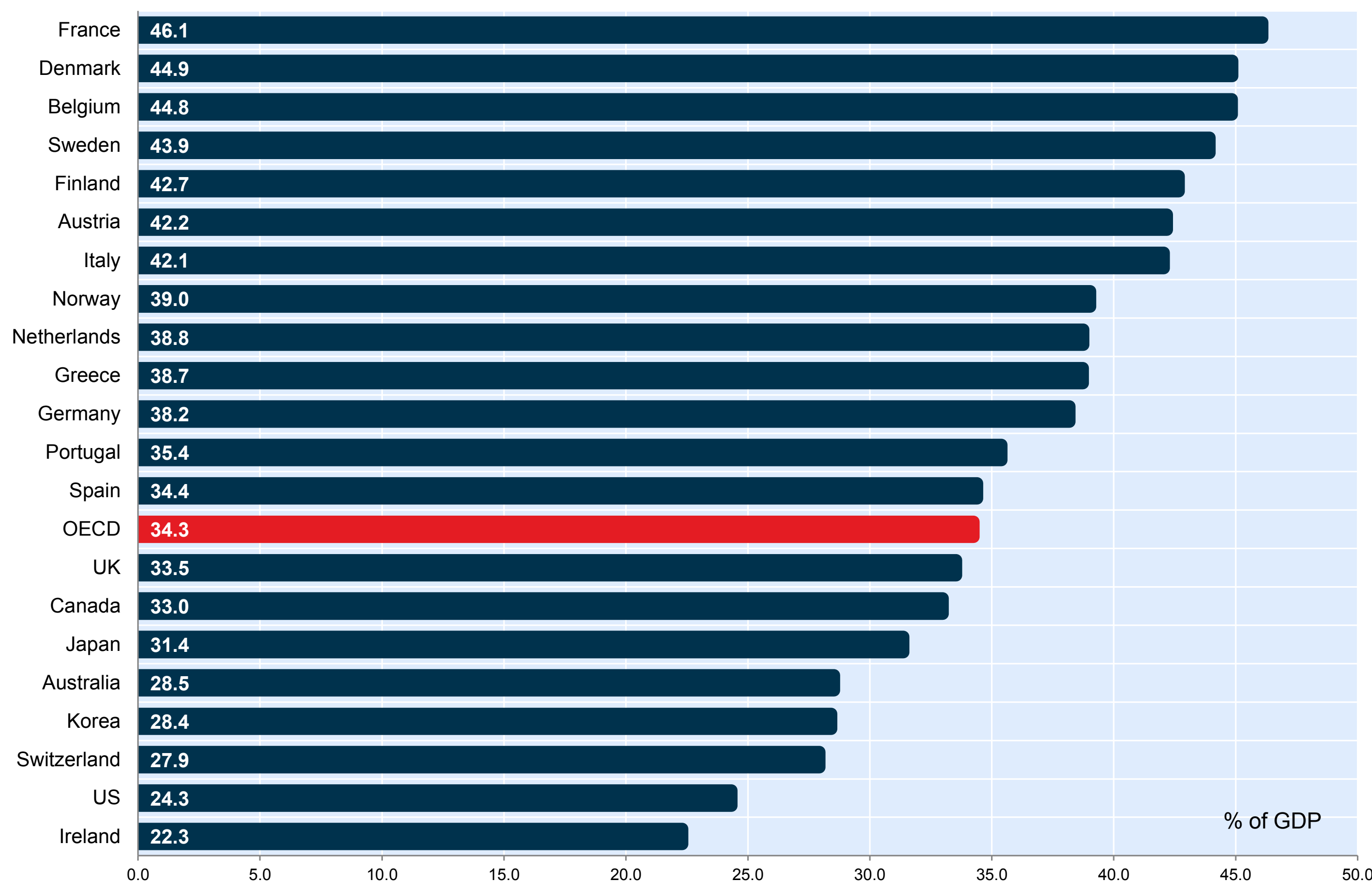
The game-changing ability of the EU to borrow

For the first time, the EU will be allowed to borrow large sums of capital on the international financial markets.

The plan is for the EU to finance this debt via new taxation powers, such as introducing a levy on plastic waste. It has also been proposed that revenue from carbon trading be allocated to this end. However, certain countries could oppose depriving their national treasuries of this income stream. If this happens, the EU could be tempted to take the politically more expedient route of taxing foreign companies. Options include imposing tariffs on imports from countries with lower environmental standards, a move that could be met with counter-tariffs from the targeted countries. Developing nations in particular would be angered to hit by a carbon border tax from countries with much higher per-capita greenhouse emissions. Another idea would be to target foreign IT corporations for alleged tax avoidance, but this could provoke reprisals from the United States.

Further, granting the EU the ability to tax on a large scale would add to the very high tax burden already prevailing in many member countries, particularly as most of them would not agree to cut domestic taxes to offset tax hikes from the EU.

[1] "How Angela Merkel's Change of Heart Drove Historic EU Rescue Plan," Wall Street Journal, July 21, 2020
[2] "'Frugal four' fight to protect EU budget rebates," Financial Times, August 18, 2020



The deal also sets major limits

For starters, the July agreement does not pool the legacy debt of all the states in a joint fund. Second, richer members, such as the Netherlands and Austria, successfully lobbied to ensure that grants to countries be subject to an oversight mechanism. This in theory allows individual member states to raise objections with the European Commission if, for instance, countries fail to implement certain reforms. Such action could potentially delay funding. If strictly enforced, this would become a major tension point.

Despite these limitations, many feel that the deal sets a precedent for EU borrowing to be deployed again in the future.

Political fractures risk widening

Once the pandemic subsides somewhat, richer EU members, including Germany, could hold up financial aid to countries that, in their opinion, have not reformed their economies sufficiently. This risk is reinforced by the anti-reformist bent of certain countries.

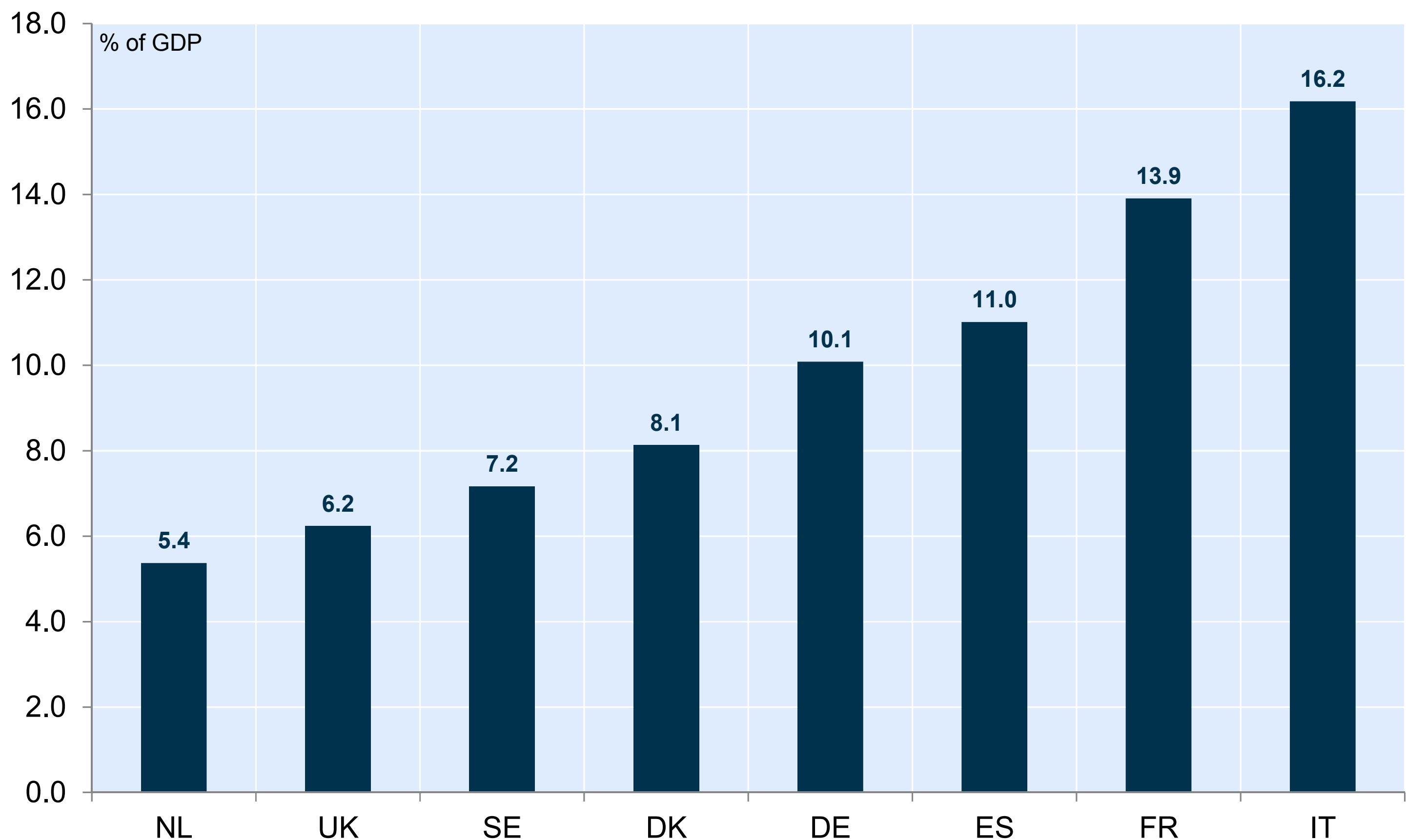
In Italy, the majority party in the current governing coalition, the far-left Five-Star Movement, not only opposes most of the reforms being pushed by the richer EU countries, it at one time advocated leaving the Eurozone. The far-right Northern League, the party most likely to lead Italy after the next election, is also against most of the economic reforms being pushed by the EU, including cutting pensions. Spain's governing coalition, which includes the far-left Podemos party, is not very much inclined to implementing market reforms either.

It may be also that the deal is being interpreted differently across the union. German Chancellor Merkel, for example, has called the grants and EU borrowing "one-off" measures to pay for pandemic-related expenses at the same time other countries have publicly acclaimed these measures as permanent game changers.

Finally, Germany's massive financial support for its economy and its backing of the recovery fund does not necessarily mean that it has changed its views towards deficit spending. Indeed, many Germans feel that their country is in a position to open the fiscal floodgates today only because it had the foresight to pay down its debt during the years of strong economic growth. This means that once the pandemic has subsided and its economy has recovered somewhat, Germany will likely seek to renew with the fiscal policies of the past, at least in part.

Pensions are a likely tension point

Public pensions are at the forefront of the challenges facing the EU when it comes to providing financial aid. The issue might best be expressed as follows: How long will the citizens of the richer EU countries put up with financially supporting countries with much more generous pensions than their own? For instance, Italy spends the equivalent of 16.2% of its GDP on pensions versus only 5.4% for the Netherlands. Italy has for years strongly resisted enacting major pension reforms or cuts.



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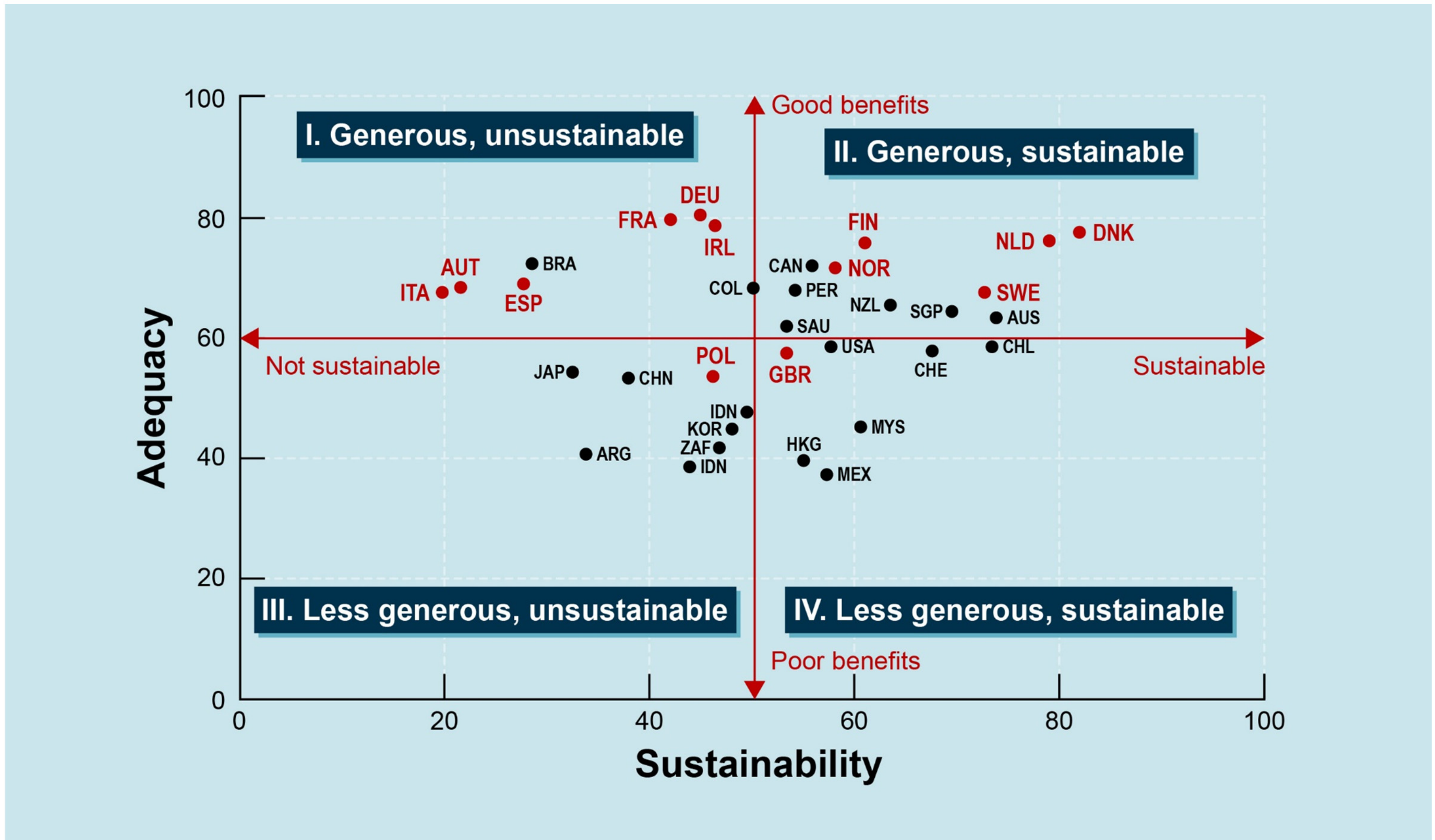
Complicating matters even further, many EU countries, including richer members, have pension systems considered unsustainable by the Melbourne Mercer Pension Index (see chart below). This index takes into account such factors as funding levels, length of expected retirements, labour force participation rate, government debt level, and economic growth trends. **Any government would face tremendous difficulty trying to convince its population that it must reform and trim pension benefits at the very same time that it is providing financial support to countries that boast much more generous pension schemes.**



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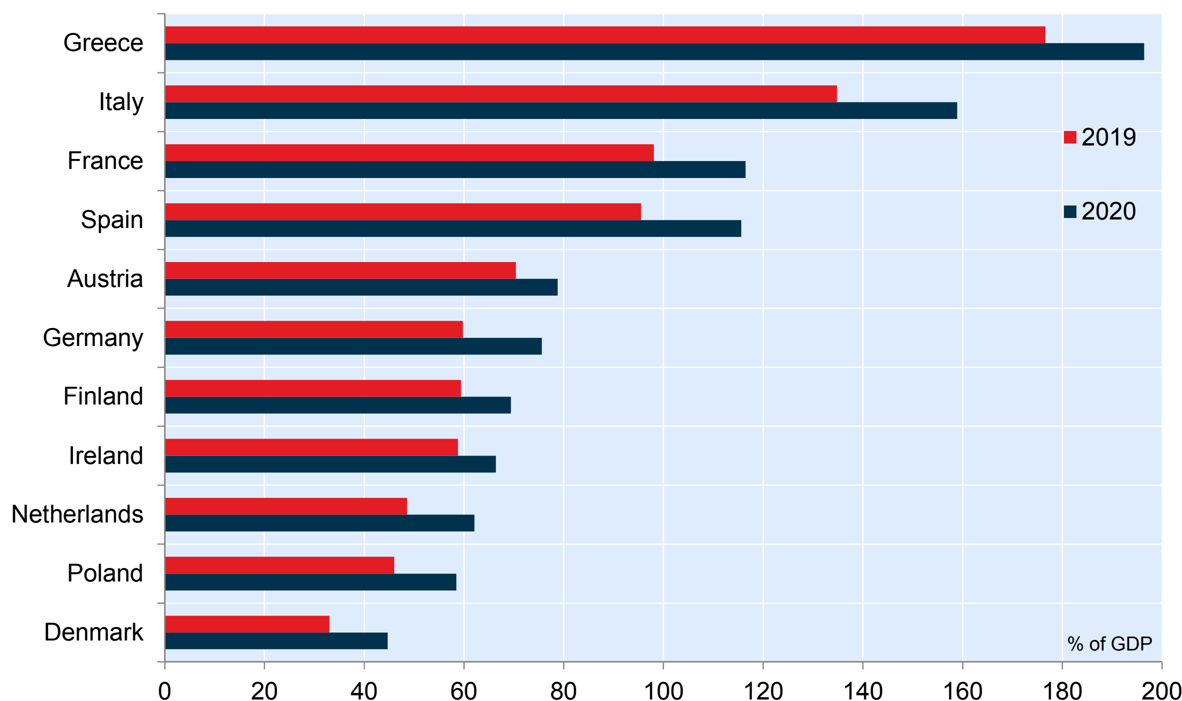
Germany's rising strength will add to EU tensions

A strong economy and low debt levels has allowed Germany to open the fiscal floodgate on a much grander scale than other EU countries. For instance, as of late May, Germany accounted for 51% of the 1.95 trillion euros in Covid-19 state aid spent by all the EU members combined, compared with only 15.5% for Italy.[3] In fact, it is highly probable that Germany will emerge from the pandemic in an even stronger economic position relative to the other EU states. This would allow German companies to gain an even greater share of the EU market, a scenario that would no doubt further anger struggling member countries.

Finally, the divide between richer and poorer members is also illustrated by their respective debt levels (see chart below).

[3] "Germany's Virus Aid Is More Than Half Total for Entire EU," Bloomberg, May 28, 2020



Conclusion

Investors have responded positively to the EU finally being able to borrow funds and provide grants to struggling countries, as this has greatly reduced the risk of Europe being hit by a financial panic in the short term.

However, this development does not fundamentally alter the EU's main geopolitical conundrum. Struggling countries want deeper financial integration and larger transfers of money with very little strings attached, while richer countries maintain that financial support and grants should come with certain conditions.

Over the longer term, and particularly if the EU economy fails to rebound strongly, it seems almost inevitable that struggling countries will blame richer EU countries for their stinginess, and richer countries will blame their poorer counterparts for making very little effort to control spending and implement economic reforms during the good times.

In order to finally begin repairing these geopolitical fractures and stimulate long-term economic growth, experts argue that the EU needs much greater economic integration. However, to make such a change without provoking a political backlash would eventually require obtaining democratic consent. This means consulting EU citizens directly via a series of referendums on matters such as EU taxation and financial transfers, instead of the current practice of often making important decisions behind closed doors and then presenting them as a fait accompli. It also means respecting results that run counter to EU objectives, and thus not repeating what occurred in 2005, when France and the Netherlands voted to reject a new EU constitution. Rather than abandon or modify the constitutional proposal, the EU renamed it the Lisbon Treaty and it got rubberstamped in the national parliaments without popular approval.[4] **The degree to which the EU manages to overcome this democratic deficit will largely determine whether it can accumulate the political capital needed to solve its long-standing challenges.**

Finally, while the July agreement was necessary to avoid a pandemic-related blow up of the Eurozone, its long-term prosperity is far from ensured without greater political integration. Getting the broad public support needed to make these changes will be very difficult, particularly since people still largely consider themselves German, French and Italian first, and Europeans second.

[4] "EU leaders cannot simply ignore the populist howl," Financial Times, May 26, 2014

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